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WHAT KENYA'S TAX POLICY MEANS FOR SMEs BUSINESSES?

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ABSTRACT

This study seeks to review Kenya's first National Tax Policy to examine whether it addresses issues that would galvanize the SME sector into formalization and tax compliance, as well as promote the growth and development of the sector. Research for the paper involved a desktop study of existing taxation legislation, expert reports, as well as SME sector strategic plans and reports published by government agencies. The focus of the study is the impact of taxation on small businesses in Kenya along four thematic areas that are central to the SME development agenda: (1) rebuilding the economy; (2) expansion to hard-to-tax sectors; (3) inclusion of innovative and other emerging sectors; and (4) driving up compliance. Study results show that while the Policy captures key issues inhibiting taxation of SMEs, it is not explicit in proffering actionable information that business owners can use to inform voluntary compliance options. The study also found that small businesses are reeling from economic hardships and require concessions to surmount their challenges. The research findings suggest that there is scanty information on SME businesses, and the government is looking into leveraging County-based licensing activities to collect primary data useful for the development of taxation policies.

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INTRODUCTION

SMEs in Kenya have long exhibited low regard for formal operations and compliance with regulations. The informal nature of operations is particularly rife among micro-enterprises. A report by the Kenya National Bureau of Statistics (2016) states that only 21% of the estimated 7.41 million SMEs are formally registered. The same report indicates that small businesses employ over 15 million Kenyans, yet, the Kenya Revenue Authority has a record of 6.1 million taxpayers – who comprise enterprises of all sizes and individuals (KRA, 2022).

Various reports attribute the low appetite for formal operations among SMEs to the poor articulation of benefits they would accrue. Instead, small businesses associate formalization and compliance with regulations with lengthy, complex and bureaucratic processes underpinned by incidences of corruption. Entrepreneurs view government and regulatory authorities at the national and county levels as business inhibitors instead of business enablers.

The lack of awareness about how their business can benefit from formalization has led many SMEs to continue operating informally. There are several business opportunities, especially in public procurement that small businesses prefer to forego than pursue registration and other business formalization procedures. The poor articulation of benefits also explains why SMEs do not file tax returns regularly.

The draft Kenya National Tax Policy 2022 is the first taxation policy document to be published by the Government of Kenya. Hitherto, the Budget Policy Statement (BPS) was the sole document that communicated government plans regarding strategic priorities and policy goals, including taxation policy. BPS is published annually by the National Treasury as the guide for national and county governments in preparing their budgets for the financial year and over the medium term (The National Assembly of Kenya, 2017). The Public Finance Management Act of 2012 anchors the Budget Policy Statement as the main instrument for ensuring public participation in the budgeting process.

The Draft Kenya National Tax Policy 2022 aims to steer a comprehensive overhaul of the Kenya tax system by introducing new taxes, increasing tax compliance and improving revenue collection. The primary objective behind this exercise is to ensure sustainable growth to achieve Kenya Vision 2030 (the country's economic development blueprint), which seeks to transform Kenya into a middle-income nation by 2030 (Government of Kenya, 2022).

The extent to which small businesses have participated in the development of the Budget Policy Statements is not

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readily known. What is clear, though, is that small businesses are still not motivated to formalize their operations. One reason for this reluctance may be the fear of opaque taxation (KRA, 2022). This study seeks to review Kenya's draft National Tax Policy 2022 to examine whether it addresses issues that would galvanize the SME sector into formalization and tax compliance. We also determine whether the Tax Policy establishes a forum for monitoring and evaluating government engagement systems and procedures.

Kenya Budget Process

The promulgation of the 2010 Constitution ushered in significant changes to the formulation of the National Budget. The new constitution set aside the exclusivity of the Executive in the development of revenue generation and expenditure plans. Departments and agencies that bore direct responsibility over the economy determined the final plans. Entrepreneurs and the public had to wait for the annual Budget Speech to know whether their taxes and commodity prices would go up or down. The constitution now mandates the Executive to follow a consultative process involving sector stakeholders and public participation.

According to the National Assembly of Kenya (2017), there are four major stages of the budget process in Kenya: formulating a proposal, approving it, implementing it and auditing/evaluating its implementation.

The formulation of the budget is the responsibility of the Executive at the National and County levels. All the ministries responsible for finance generate policies that direct the economies and finances of their areas of jurisdiction. The National Treasury creates a proposed Budget Policy Statement; the county governments generate County Fiscal Strategy Papers. These proposals are presented to the public to give them a chance to voice their opinions.

After the formulation procedures are complete, the budget moves on to the Legislative arm of the Government for approval. Parliament handles this at a national level; County Assemblies take care of it at a county level. The approval stage involves the adoption of the Budget Policy Statement and County Fiscal Strategy Papers; approval of budget estimates; and enactment of the Appropriation Bill—as well as any other Bills required to carry out budgetary proposals.

The implementation stage involves carrying out the budget proposals passed at the approval stage. The Executive at both national and county levels is responsible for implementing budgets. Parliament monitors the finances of both National and County governments every three months by examining documents related to revenues and expenditures. The Controller of Budget's quarterly budget implementation report, and the national and county governments' quarterly budget implementation reports are the key implementation and oversight documents.

The annual budget cycle ends with audit and evaluation. The Office of the Auditor-General is in charge of audits, while The Office of the Controller of Budget handles evaluation. The Auditor-General reports on the financial accounts of the National and County governments. The Controller of Budget reviews previous fiscal year expenditure by the National and County governments. Both reports are tabled in Parliament for review and adoption.

The Importance of SMEs to Kenya's Economy

Approximately 7 million small and medium-sized businesses operate in Kenya today. All industries, including trade, manufacturing, agriculture, tourism and financial services, are represented by these businesses (KNBS, 2022). They play an essential role in the last-mile delivery of goods to consumers and are responsible for up to 90% of private sector enterprises across various sectors. Most are in retail/wholesale trade, manufacturing and catering value chains (KNBS, 2016).

Small business is a key component of the economy in Kenya. The country's small businesses employ more than 15 million Kenyans, while they make up 29% of the GDP (KNBS, 2016). SMEs have played an important role in technological innovation in Africa, including mobile telephony technology. 76% of Kenya's population is under age 35, well-informed and exposed to technology; this segment grew up during a period when mobile phones became widely used across the continent. It is not uncommon for small businesses in Africa to use mobile technology for financial transactions such as payment processing or banking transactions.

The importance of SMEs to Kenya's economy cannot be overstated. SMEs are critical to economic growth because they provide jobs for many Kenyans, boost exports and create new opportunities for the consumption of goods and services. They also contribute significantly to government revenues through taxes on sales and profits. In addition, they can play an important role as catalysts for innovation (KNBS, 2016).

Retailers who operate small businesses (SMEs) have been credited with helping to sustain the industry value chain in several ways. For example, SMEs provide last-mile delivery services for food and beverage manufacturers, telecom companies and banks that provide financial services to consumers. Banks have begun using their established distribution networks to deliver "agency banking" concepts. The 2021 FinAccess Household Survey shows that retailers extend some of these goods and services to consumers on a credit basis. The said survey records that informal sources are the third most used source of consumer loans after mobile loans and banks. Within these informal sources of loans is cash or goods/services extended by shopkeepers as an extension of their businesses for additional income (Central Bank of Kenya et al., 2021).

According to various reports, SMEs can double their contribution to the economy if they are granted the support they need. The support SMEs need aligns with the key challenges that they face—access to business development support, access to capital, access to markets, and access to knowledge resources. To address challenges faced by SME businesses, the government published three policy documents aimed at strengthening the SME Sector: (1) The Micro and Small Enterprises Act (2012), which defines SMEs and statutory bodies responsible for their development; (2) Kenya Vision 2030, which outlines opportunities for MSEs in the country's development blueprint; and (3) The Kenya Micro and Small Enterprises Policy (2020), which outlines the national support structure and interventions for SMEs.

This study examines the extent to which the draft Kenya National Tax Policy (2022) encapsulates ideas proffered by the mentioned documents. We examine the contribution the Tax Policy is poised to make in the development of the SME sector.

SMEs and Taxation

The International Labour Organization (ILO) argues that the way businesses are taxed affects entrepreneurs' decision to start or close a business, whether to incorporate or not and the growth prospects of a business. ILO further asserts that it is not just the tax rate that is of importance but also how tax administration is conducted. Understanding tax legislation and how it impacts business are key determinants of the extent to which an entrepreneur will declare business income (Marchese, n.d.).

Entrepreneurs in Kenya find the cost of regulatory compliance to be high. The high costs stem from the requirement to procure multiple licenses throughout a calendar year, levies charged by county governments (depending on activities carried out by a business), and the need to hire subject-matter experts for purposes of filing statutory business reports – including tax returns. An estimated 7 million SMEs have engaged 15 million people - indicating about two employees per business (KNBS, 2016). A typical SME would hire people whose role gravitates to customer support or sales completion. Filing tax returns often requires an SME to employ accounting staff either permanently or temporarily. Goods retailers find the extra hire requirement high in comparison to margins made from sales of goods.

Another area of concern for businesses is a demonstration of value for the taxes and levies charged by national and county governments. First, the cost basis is unknown. Secondly, they are not predictable as the rates could be changed annually (during the national and county budgeting process) or at any time through special government notices. The aggregate costs of licenses, levies and taxes may end up being out of reach of micro-enterprises.

The Kenya Revenue Authority reported that there are 6.1 million registered taxpayers (KRA, 2021). This is a small number compared to the 17.4 million employed persons (Statista, 2022), and over 7 million small businesses (KNBS, 2016). Tax administration in Kenya relies on the formalization of employment and business activities. It starts with the registration of the taxpayer – be it as a corporate or an individual. In Kenya, the registration of taxpayers is often tied to formal employment and the registration of businesses. Employers are expected to deduct and remit income tax (Pay as You Earn) on behalf of their staff. As for businesses, those whose monthly turnover exceeds KES 80,000/- (USD 677.19) are required to register to comply with Turnover Tax requirements (KRA, n.d.).

The informal sector constitutes an important part of the Kenyan economy, being related to employment creation, production, and income generation. A review of the government policies informing the development of local enterprises shows a clear intention to support the development of micro-enterprises by, among other things, transitioning the majority to the formal sector. Our study of the Draft Kenya National Tax Policy looks into opportunities for formalization of small businesses through enabling tax policies.

Study Themes

The strategic intent of the Draft Kenya National Tax Policy (2022) is to promote an efficient and fair tax system that promotes equity in tax administration and a predictable tax environment for businesses. Our review of the Policy focuses on four thematic areas: (1) the need to rebuild the economy; (2) expansion to the hard-to-tax sectors; (3) inclusion of innovative and other emerging sectors; and (4) driving up compliance. These four are central to the development of SMEs.

LITERATURE REVIEW

Tax administrators continually face the dilemma of seeking to grow revenue collection through widening the tax net to include small businesses, yet the target businesses seem unable to afford tax burdens. Instead, they need tax concessions. A report by Barreix and González (2020) aptly captures this paradox by stating that small individual taxpayers and SMEs are the highest number of taxpayers in Latin America and the Caribbean, yet they contribute only 0.1% to 3.9% of tax collections. The report traces the root cause of the tax collection impasse to the inability of small businesses to transition from the informal subsistence economy to more productive and formal participation in the economy. Atawodi and Ojeka (2012) argue that this stagnation may be by design as businesses would take deliberate steps to avoid reporting, filing and payment requirements that they find burdensome and costly.

The importance of SMEs to economies around the world is well known. They are instrumental in providing employment and driving innovation across various sectors. It is common to find governments setting up state agencies and other support structures that focus on policies that facilitate SME promotion, development, and regulation. Micro and Small Enterprises Authority, the Ministry of Micro, Small and Medium Enterprises, and SEBRAE are such institutions in Kenya, India and Brazil. It is usually the expectation of many governments that the efforts of SME-focused institutions will result in the transition of businesses from informal outfits to medium to large-sized enterprises capable of competing effectively in domestic and international markets. However, various reports we examined revealed that, on average, SMEs in developing markets last only two to three years, mainly due to cash, market and knowledge constraints.

Governments have looked into mainstreaming SMEs by encouraging formality with the promise of business opportunities. In Kenya, for instance, small businesses owned by the youth, women, and persons with disabilities are allocated 30% of public procurement opportunities. In addition, there is a 40% allocation of public procurement to locally produced goods and services (Government of Kenya, 2016). In the case of India, the government has focused on SMEs in fabric and ICT value chains – where the country has a clear competitive advantage in the global market space. Two statutory bodies are in place to support the development of MSEs in the fabrics industry - the Khadi and Village Industries Commission and the Coir Board. In the ICT space, the government made it possible for eCommerce giants, Facebook and Amazon, to engage with local businesses - thereby forging ICT with Trade (Invest India, n.d.). These kinds of affirmative action, together with capacity-building programmes delivered through SME-focused state agencies, are designed to mitigate the challenges of cash, market access and business development knowledge that are said to be responsible for low productivity among small businesses.

As small businesses grow and formalize, the progressive action is to include them in the taxation net. The trend has been to use preferential tax regimes (PTRs) for small businesses. Machese (n.d.) defines PTRs as special fiscal regimes that offer a lower tax rate and simple tax compliance requirements than mainstream tax regimes to a target group. Chen et al. (2011) present compensation for limited access to capital financing as the main argument for PTRs targeted at SMEs. Other supporting arguments include high costs associated with compliance and depressed cash flow among small businesses. OECD (2015) suggest that careful targeting needs to accompany preferential regimes since SMEs are heterogeneous, thus the need to address specific sector-based challenges.

There have been mixed outcomes of applying preferential tax regimes in different markets. Concessions given to SMEs are to foster business development. Chen et al. (2011) point out that the risk of preferential treatment is that a business could deliberately stop growing to continue enjoying the tax benefits. Where business growth is inevitable, the market could witness a continuous break-up of businesses into units small enough to comply with a government's definition of a "small business". Thus, governments pursue a strategy of having preferential tax measures on a temporal basis to allow for frequent review opportunities. Several Eastern Europe and Central Asian countries instituted preferential taxes in the late 1990s to early 2000s but then halted the schemes in mid the 2000s to curb abuse by large corporates. All organizations moved to the regular tax scheme. What followed was reduced tax reporting and compliance. Reinstatement of concessions saw two-thirds of businesses that had migrated to the general tax regime move back to the preferential regime (Engelschalk & Loeprick, 2015). In a different approach, Japan reduced or abolished tax on specific lines for a year as a short-term measure to boost cash flows for SMEs. Chile had a similar programme restricted to three years (Zhang & Shvili, 2020).

Kenya's Draft National Tax Policy proposes a presumptive tax approach for SMEs. Marchese (n.d.) explains that governments have turnover (sales revenues), capital assets, employment, or utility services consumption as options for proxy variables in tax computation – instead of using taxable profits. Kenya currently uses turnover. We are yet to see whether it shall be the only variable or if there will be more options.

METHODS AND METERIALS

This study was a desktop research focusing on the impact of taxation policies in the development of SMEs in Kenya. It involved summarizing and collating existing secondary data relevant to taxation policies and their impact to SMEs in a number of markets. Reports and strategic plans authored by taxation experts, as well as yearly reports on performance of the Kenya Revenue Authority, was evaluated to enrich this study. This helped the researchers generate insight on the published Draft Kenya National Tax Policy.

RESULTS

Small and medium-sized enterprises (SMEs) play an essential role in the world economy, especially in developing countries (Zhang & Shvili, 2020). Various policy documents published by the Government of Kenya agree on the importance of the SME sector to Kenya's economy. Our reading of the National Tax Policy shows the intention of the government to broaden the tax net to include more SMEs drawn from two business areas: (1) agriculture and informal sectors; and (2) online-based businesses. The two segments are characterised as being "hard to tax". Therefore, the tax administration will require careful consideration.

Agriculture and informal sectors are characterised as being reliant on physical cash (in conducting transactions) and maintaining poor records on incomes and expenses (Central Bank of Kenya et al., 2021). Turnover Tax in Kenya is payable by businesses that exceed Ksh 1,000,000 (USD 8,435.26) per annum but does not exceed Ksh 50,000,000 (USD 421,762.97) (KRA, n.d.). Kenya's Ministry of Industry, Trade and Enterprise Development has classified businesses per, among other parameters, their annual turnover (MOITED, 2020). Given the Kenya Revenue Authority's criteria for Turnover Tax, Small and Medium-sized businesses are within the scope of the turnover tax. The Kenya National Bureau of Statistics states that all businesses classified as either small or medium-sized are registered and the majority have annual turnovers of at least Kshs 600,000 (USD 5,061.16). The majority of medium-sized businesses have turnovers exceeding Kshs 12,000,000 (USD 101,223.11) per annum (KNBS, 2016).

It is noteworthy that, in Kenya, medium-sized enterprises are those with an annual turnover of Kshs 5 million (USD 42,176.30) to Kshs 800 million (USD 6,748,207.44) (Kenya Agribusiness and Agroindustry Alliance, 2017). This means that a medium-sized enterprise will be required to transition from turnover tax to the general corporate tax regime as its income grows. Engelschalk and Loeprick, (2015) caution that if a business determines that migration from the presumptive regime to the standard regime will mean higher taxes, then such a business will take steps so to remain small and thus operate within the lower tax band.

Need to Rebuild the Economy

Taxes and levies are essential for the development of any country, as they are the primary source of funds that a government can use to provide citizen services and infrastructure. Tax policies should therefore focus on increasing tax collection while also encouraging high compliance. The effectiveness of a tax policy in this regard can therefore be measured by (1) growth in collections; (2) growth in compliance – particularly voluntary compliance; (3) sustainability of the tax base; and (4) efficiency in tax administration.

The draft National Tax Policy recognises that Kenya needs to rebuild its economy and create jobs. The Policy states that the government will ensure that tax measures are designed to promote growth, encourage investment and promote economic development. The Policy also recognises the need to have specific reviews with the active involvement of stakeholders at least once every five years. This move allows the National Treasury and Kenya Revenue Authority (KRA) to engage with taxpayer groups on market dynamics that need to be factored into tax strategies, as well as align taxation plans with the Kenya Vision 2030 – the country's economic development blueprint.

It is clear from this policy how important it is for government agencies such as KRA and National Treasury to be engaged directly with stakeholders to ensure that their views are taken into consideration while designing policies relevant to them. The draft Policy also calls for improved monitoring of tax compliance as well as effective enforcement mechanisms aimed at ensuring compliance by taxpayers with their obligations under tax laws.

A scrutiny of the Draft Policy reveals that the immediate plan is to expand the tax net to include agriculture, informal and emerging sectors – specifically businesses involved in eCommerce. Though the Policy has not been considered and approved by Parliament, the Kenya Revenue Authority has already captured its intent to focus on these sectors in its strategic plan (KRA, 2021). Presumptive tax is among the measures proposed to bring the agriculture and informal sectors into the fold. The digital sector is levied a 1.5% tax on income from services accrued or derived in Kenya through a digital marketplace and the Policy proposes an increase in tax yields from the sector.

Although businesses have yet to fully recover from the effects of the COVID-19 pandemic, the World Bank asserts that Kenya's economy is recovering faster than originally predicted. In 2021, real GDP increased by 7.5%, higher than the estimated growth in Sub-Saharan Africa of 4%. (Mathenge et al., 2022). Costs of doing business have shot up mainly as a result of higher international oil prices as per a report by Mathenge et al (2022). It is our considered view that businesses, at this time, need to access cash to aid their recovery. Chile, for example, reduced the corporate income tax rate from 25% to 12.5% for SMEs for the fiscal years 2020, 2021 and 2022 (Zhang & Shvili, 2020). The Policy has not proffered any concessions to free up cash for SMEs. Tax concessions can help small businesses to retain a higher proportion of their earnings, enabling them to obtain external finance (Marchese, n.d.).

Expanding to Hard-to-Tax Sectors

The Draft National Tax Policy aims to expand the tax base in both the agriculture and informal sectors. Currently, there are tax regimes covering these sectors, but revenue collection and administration are challenging on account of their informality. The majority of farmers are smallholders; small-scale operations account for over 70% of agricultural production and meet about 75% of the national food demand (Njenga, 2016). In Sub-Saharan Africa, presumptive tax regimes have mostly been used to collect some tax revenues from large domestic informal sectors (Marchese, n.d.). There is a need to examine how these regimes could be more effectively used as instruments for formalizing SME operations in the informal sector.

The informal sector is characterised as being heterogeneous, which makes it difficult to apply a blanket taxation regime without creating an imbalance in the costs or burden of compliance for smallholder farmers and informal traders. (Atawodi & Ojeka, 2012). Tax compliance costs for small businesses are higher than for large businesses. This is because a larger company's tax compliance costs are proportionally less expensive when compared to a smaller company's tax compliance costs. The reason for this is that while total tax compliance costs are higher for larger companies in absolute terms, they are more burdensome when measured against sales and income (OECD, 2015).

Engelschalk and Loeprick (2015) argue that the risk of factual discrimination against low-profit trading businesses can be avoided by introducing a rate differentiation in the turnover tax regime. By reducing their tax burden, small businesses in the trade segment will be able to increase their profits and grow their business. However, data on the performance of small businesses are currently not up to date. The last comprehensive study on the SME sector was conducted by the Kenya National Bureau of Statistics back in 2016; this should be an annual exercise given the importance of the sector to the economy. The Kenya Revenue Authority can leverage provisions made in its tax policy for consultative forums to engage with MSE Associations and other interested parties to begin generating data that can be used to justify the scope and level of rate differentiations.

Innovative and Other Emerging Sectors

The Kenya Economic Survey published by KNBS (2022) records the growth of online businesses and digital connectivity on account of markets seeking alternative means of accessing goods and services at the height of the COVID-19 pandemic. The Government of Kenya imposed movement and physical interaction restrictions, otherwise known as lockdowns, which impacted trade routines among retail businesses and consumers. This presented an opportunity for technology firms to deliver innovative online solutions to businesses. The KNBS (2022) report states that as a result, the value of output from the ICT sector grew by 15% from KSh 494.3 billion (USD 4.17 billion) in 2018 (before COVID-19) to KSh 566.3 billion (USD 4.78 billion) in 2021. The number of Internet Service Providers grew by 64% over the same period. The value of mobile commerce transactions grew by 63.2% to reach KSh 15.3 trillion (USD 0.13 trillion) between 2020 and 2021 only.

The Kenya Revenue Authority (2021) interpreted the value of output from the ICT sector as a clear sign of the migration of businesses to the digital economy. It is noteworthy that the Digital Service Tax came into force in 2021 and KRA now planned to increase compliance with VAT and Income Tax. However, Kumar (2021) argues that while there was a surge in digital marketplaces, many businesses went online as a stopgap measure to mitigate the impact of lockdowns and other restrictions placed on businesses. He notes that eCommerce was new to many businesses, and they now also had to contend with complex taxation, data privacy and other nuances unique to online trading. In addition, not all online marketplaces operated from other countries and thus local businesses were more exposed to international competition. (Atawodi & Ojeka, 2012).

At the time of coming into effect on 1st January 2021, Digital Services Tax was at 1.5% of the income accrued or derived in Kenya. A report from Njanja (2022) indicates that Kenya plans to double the rate to 3% beginning July 2022 as a means of increasing domestic revenues and narrowing fiscal deficit. Retail trade margins for fast-moving consumer goods are very thin, with some reports indicating margins of 6%. Thus, a tax of 3% will erode progress made in eCommerce innovation as the tax would stifle working capital for small businesses (Kumar, 2021). In contrast, the taxation policies in Singapore have encouraged the establishment of technology businesses in the country. The country's tax code gives certain concessions to companies that are resident in Singapore that acquire intangible assets and as a result, Singapore is a global IP hub and leading knowledge-based economy (Deloitte, 2021).

Driving Up Compliance

It is estimated that 30 million persons in Kenya are aged above 18 years. Slightly more than half of this population is employed (Statista, 2022). KRA reports that there are 6.1 million active taxpayers in their records (KRA, 2021). Considering that the taxpayers include registered businesses, we can safely deduce that KRA has netted less than 35% of the employed base. KRA plans to immediately enlist an additional 2 million taxpayers from the informal sector, and digital sector and strengthen tax administration.

In terms of compliance, KRA’s strategic plan states that filing of returns is at 68% of taxpayers and payments of taxes are at 88% of taxpayers (KRA, 2021). Traditionally, KRA has used sanctions and penalties to enforce compliance. The Draft National Tax Policy proposes an enhancement of the same measures. Al-Ttaffi et al. (2021) argue in favour of using tax incentives to encourage voluntary compliance, whereas Marchese (n.d.) advocates for a system of preferential tax rates, which would simplify tax administration, broaden the tax base and thus raise additional revenues.

Brazil uses the Single Replacement Tax approach to aggregate what would be several lines of taxes and levies into one tax. Social security payments are incorporated into the single tax, known as Simples Nacional (Pesssa et al., 2015). The Single Replacement Tax is calculated against gross revenue and the rate encompasses a component of the replaced taxes. Progressive rates apply based on the level of income. The most important element of the Brazilian model is the systematic engagement between tax administrators and SEBRAE (the Brazilian Support Service for Micro and Small Businesses) (Pesssa et al., 2015). This enables the government to drive compliance while articulating the benefits of compliance to small businesses

According to research from the Organization for Economic Co-operation and Development, developing countries face difficulties in collecting taxes because of a lack of coordination between business operations and tax obligations. SMEs use separate systems for their business operations and tax obligations (OECD, 2022). The businesses use operating systems to obtain goods and services from other businesses within their value chains (like suppliers), connect to their financial service providers (internet/mobile banking) and service customer needs (eCommerce or sales tills). The Kenya Revenue Authority has provided an online portal (iTax platform) for filing taxation information. The challenge is that output data from business operation systems may not align with the input data required to fulfil tax filing obligations. The businesses often have to incur additional tax compliance costs by hiring persons to complete filing requirements.

DISCUSSION

The cost of compliance with government regulations is high and of little value for SMEs. Businesses must apply for multiple licenses throughout the year, on top of complying with complicated tax regulations. Additionally, many businesses prefer to remain informal as the registration requirements and procedures are not readily understood. To achieve full compliance with business licensing and reporting requirements, SMEs need to engage with National Government agencies as well as County Government agencies. Procedures and timelines at these levels are largely invisible to small businesses. Our study finds that SMEs perceive that government rules and regulations do not foster business growth. Instead, they exist for government revenues without any residual value to entrepreneurs.

Tax compliance is notoriously low among small businesses, but the National Tax Policy was expected to act as a “sales pitch” for tax compliance. Al-Ttaffi et al. (2021) found that tax penalties have no significant impact on curbing tax noncompliance among SMEs, although the government's use of reliable data on profitability would be helpful. Engelschalk and Loeprick (2015) point out that small businesses with low-profit margins find turnover tax rates unattractive because they are usually arrived at by the government without using reliable data on the profitability of SMEs. However, there is an opportunity for tax policy framers to engage with the SME sector to drive formalization and compliance while apportioning incentives where applicable.

The Draft National Tax Policy provides for a comprehensive review of tax laws every five years. One of the priorities in the current period would have been providing incentives under the Digital Services Tax (DST) if organizations assist small- and medium-sized enterprises to organize their business records. It is this study’s view that the priority at this stage should be on the registration of new taxpayers without the burden of immediate tax compliance. This can be achieved quicker for SMEs that are looking to expand their markets through online infrastructure or use digital business systems, where business transaction records in these platforms can be designed to fit tax reporting requirements. As it stands today, DST is not well understood by many taxpayers and doubling its rate may dissuade patronage of digital platforms and slow down government efforts to comply with this new law (Njanja, 2022).

For small businesses, matters related to taxation can be complicated. In Kenya, for example, tax requirements are usually delivered through a legislative process and presented to the public in documents that use technical jargon and legalistic language. A typical SME owner may not readily evaluate and interpret the implications of tax laws for his/her business. It is noteworthy that a report published by the Kenya National Bureau of Statistics indicates that 60.6% and 90.2% of licensed and unlicensed establishment’s owners have secondary level as their highest educational attainment; 71.1% of unlicensed business owners have not gone beyond primary school (KNBS, 2016).

The OECD (2012) recommends that tax administrators focus on the end-to-end process surrounding business licensing rather than just the tax compliance processes. Most businesses acquire annual trade licenses from their respective counties; the use of presumptive tax at the point of purchasing the license would be an ideal starting point for analysing data collected from County licensing processes. Our scan of County licenses shows that there are three categories based on the core business (sector and subsector), location (whether rural or urban) and size of the company (employee size or annual revenue). Tax policy formulators can leverage this information to formulate future taxation measures.

Barreix and González (2020) propose that pension and health coverage be included in the remittance of taxes by providing benefits to employees and their families, including those who are not members of social security programs. Such an approach would present immediate, direct and tangible benefits to small- and medium-sized enterprises. It is noteworthy that universal health coverage is part of Kenya's economic development blueprint (Kenya - Universal Healthcare Coverage, 2018). There may be benefits associated with bundling NHIF payments with SME tax payments to signal government-sponsored health care for all taxpayers. National Social Security Fund payments could also be included.

Lessons from Brazil

To motivate the formalization of SMEs, the Brazilian Government introduced *Simples Nacional* tax regime, which was well received in the market. *Simples Nacional* covers 65% of Brazilian companies and accounts for one-quarter of federal tax exemptions (Pesssa et al., 2015). The tax regime was a part of a wider government scheme aimed at supporting the development of SMEs. The reforms included simplifying licensing and access to finance.

One of the key success factors in tax administration is the close collaboration between the government and SMEs through *SEBRAE* (the Brazilian Support Service for Micro and Small Businesses). *SEBRAE* is a quasi-governmental organization which acts as the main service delivery body in Brazil's SME ecosystem. It has the equal participation of private and public entities. Founded in 1972, *SEBRAE*'s activities are coordinated at a national level via the National Deliberative Council and executed through field offices evenly distributed across all 27 Brazilian states. *SEBRAE* raises the bulk of its income from contributions made through the payroll of all member organizations and fees charged for courses offered to businesses. The funds raised meet operational overheads, and more importantly, the development of programmes and initiatives aimed at creating sustainable growth conditions for small businesses. Its broad membership and wide network of service centres make it an influential player capable of driving the SME agenda effectively. *SEBRAE*'s footprint allows it to adapt to unique scenarios that SMEs may bring to the fore from state to state

The consultative interactions between Government and *SEBRAE* provide SMEs with legitimacy, organizational coherence and influence over economic policy decision-making. In exchange, the government leverages *SEBRAE'*s network and influence to promote deep reach into the business community, reduce bureaucracy in government processes, and provide options for adapting policies to fit varied situations.

Lessons from India

India is recognized for having well-crafted fiscal and monetary policies with an economic growth rate, according to World Bank estimates, peaking at 7.5% to 12.5% at one time – before declining to 4% following weaknesses in the financial sector, a slowdown in private consumption and impact of COVID-19. The country is a hub for information technology services. The India Brand Equity Foundation estimates that the domestic revenue of the IT industry is US$ 45 billion and export revenue is US$ 150 billion per annum. The sector contributes 8% of GDP and employs about 4.5 million people. It is noteworthy that Kenya looks to India for some key development plans and models. Trade, cottage industries, microfinance and cooperative movement models applied in India have contributed to the structures currently in use in Kenya. In addition, the concept of the Constituency Development Fund in Kenya was borrowed from a similar scheme that was successfully implemented in India.

The Indian Government has provided several growth opportunities for the SME Sector. There is a framework for SMEs to raise capital through stock markets – again a feature that Kenya intends to implement. Government e-Marketplace (GeM) and other online marketplaces have been deployed for businesses to market their products. It is noteworthy that public sector procurement is conducted via the GeM platform. As of June 25, 2021, GeM portal has served 6.87 million orders worth Rs.116,291 crore (US$ 15.67 billion) from 2 million registered sellers and service providers for 52,651 government buyers. The adoption of digital payments has seen 72% of SME payments done through the digital mode compared with 28% of cash transactions. The individual business transaction data generated through digital platforms are used to craft taxation policies and sector growth programmes. There is also a drive to formalize businesses through an online registration platform that is focused on the registration of SMEs.

India's approach has been to focus SMEs on sectors/industries in which the country has a clear competitive advantage in the global market space. Indian fabrics, for instance, are renowned across the world. Thus, there are two statutory bodies put in place to support the development of SMEs in the fabrics industry - the Khadi and Village Industries Commission (KVIC) and the Coir Board. India is also a key player in the global ICT space - where it has exported labour and technology. The Government made it possible for eCommerce giants, Facebook and Amazon, to engage with local businesses - thereby forging ICT with Trade (which is another strength of Indian entrepreneurs).

Another key element in India's regulatory environment is the consistent review of policies and interventions with the input of stakeholders. The underlying objective of the reviews is to ensure that desired government policy outcomes are achieved. Review outcomes are made public to keep SME actors accountable and leverage the distribution of reports to publicise investment opportunities among entrepreneurs.

In the wake of the COVID-19 pandemic, several small businesses in India moved online to sell their products. According to Kumar (2021), businesses that migrated to eCommerce platforms ended up being disadvantaged by the Goods and Services Tax Act. The GST Act allows merchants with less than 1.5 crores in annual revenue to register for a Composition Scheme. The tax regime makes life simpler for traders by allowing them to pay a single rate of 1%. However, when traders under this scheme sell on an online marketplace, they are subject to the full rate of tax on all transactions. So instead of supporting the small businesses through the transition, the taxation policy stifled relief at a time of crisis.

CONCLUSIONS

Having a national tax policy is a step in the right direction as it will allow taxpayers to plan. The Draft National Tax Policy in its current form does not meet the threshold of providing actionable information for business owners. There is minimal information on the taxation strategy which bears the risk of creating an uncertain business environment.

On the positive, the Policy provides for comprehensive reviews of tax laws at least once every five years. This will afford stakeholders to engage in market realities as well as align with government priorities. Other economic planning instruments such as the Vision 2030 Medium-Term Reports and Economic Survey can then be used to align taxation plans.

A review of various reports brings out the need to use the current wave of tax policies to set the stage for the future. It will be a challenge for the government to achieve a giant leap in compliance ahead of putting forth a strong case for voluntary compliance. The focus of the first five-year cycle should be on the registration of taxpayers, compilation of reliable data and cushioning businesses from the prevailing economic hardships. Close collaboration with County-based licensing activities should be leveraged to collect basic data on businesses – who they are, where they are, what they do and their sizes. This information would provide a foundation for developing taxation policies.

The Policy should take an incentive-driven approach to compliance. Implementation of a Single Replacement Tax regime that incorporates all licensing and social payment requirements should be adopted for micro and small enterprises. Taxation should not be viewed just as a means of revenue collection by the government. The taxpayer would also want to understand the tangible benefits of compliance. Layering delivery of medical cover (NHIF payments) and a pension scheme (NSSF payments), however basic, will go a long way in meeting the need for tangible benefits. The aim is to make it easy to comply and difficult not to (OECD, 2012).

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